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In the Supreme Court of the United States

OCTOBER TERM, 1972

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court (Appendix A, *infra*, pp. 18-41) is reported at 57 T.C. 46. The opinion of the court of appeals (Appendix B, *infra*, pp. 42-69) is reported at 472 F. 2d 796.

JURISDICTION

The judgment of the court of appeals (Appendix C, *infra*, pp. 70-71) was entered on January 26, 1973. By order dated April 18, 1973, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 25, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, upon the amendment of respondent's certificate of incorporation to eliminate its outstanding 47,059 shares of $50 par 5% cumulative preferred stock and the issuance of a 5% debenture in the face amount of $50 in lieu of each share of the eliminated preferred stock, respondent became entitled to deductions for amortizable bond discount.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Sections 163 and 1232 of the Internal Revenue Code of 1954, and of Treasury Regulations on Income Tax (1954 Code) §§ 1.61-12 (as effective in 1957) and 1.163-3 (effective since 1968) are set forth in Appendix D, *infra*, pp. 72-76.

STATEMENT

Respondent is a Delaware corporation engaged in business in Shawnee Mission, Kansas. In July, 1957, in addition to an issue of $1 par common stock, respondent had outstanding an issue of 47,059 shares

of $50 par, 5% cumulative preferred stock, on which there were then dividend arrearages of $10. These preferred shares were redeemable in whole or in part at the discretion of respondent's board of directors, or through the operation of a sinking fund, at a price which was, in 1957, $51 per share plus accrued dividends. When, however, there were dividend arrearages on the cumulative preferred shares, there were restrictions upon acquisition and retirement in transactions with individual shareholders. Upon voluntary liquidation of the corporation, holders of the preferred shares were entitled to $50 per share, plus accrued dividends, prior to any distribution to common shareholders. (Appendix B, *infra*, pp. 43-44.)

As a result of action by respondent's board of directors in April, 1957, and a two-thirds vote by both classes of its shareholders in July, 1957, respondent's certificate of incorporation was amended, effective August 1, 1957, to eliminate the cumulative preferred shares and to increase the par value of the common shares from $1 to $3. By the same action, an issue of 5% debentures due July 1, 1975, was authorized in the aggregate amount of $2,352,950, and it was provided that a 5% debenture in the face amount of $50 was to be issued for each share of the eliminated $50 par, 5% cumulative preferred stock. A warrant to purchase one-half share of common stock at $10 per share was also issued for each share of the eliminated preferred in lieu of the dividend arrearages. There were sinking fund provisions with respect to the debentures comparable to, but not identical with,

the previous sinking fund for the preferred shares. After this transaction took place, it was reflected on respondent's books by debiting preferred stock for the $2,352,950 eliminated, and crediting the liability account for the newly issued debenture in the same amount of $2,352,950. (Appendix A, *infra*, p. 23; Appendix B, *infra*, pp. 44-48, 49-50.) Bid and asked prices for respondent's preferred shares ranged around $33 per share in July, 1957.

On its income tax returns for fiscal years ended April 30, 1958 through 1967, respondent claimed deductions for bond discount asserted to have been created upon the issuance of its $50 debentures, and to have been measured by the difference between the asserted market value of $33 for each share of the eliminated preferred stock and the $50 face amount of each debenture issued in lieu of a share of preferred stock. The deductions in earlier years were included in losses carried over to fiscal 1967. The Commissioner of Internal Revenue disallowed a deduction of $109,804 for bond discount for 1967, and $321,657 of claimed loss carryovers from prior years by virtue of deductions for bond discount claimed in those years, and a deficiency was asserted for 1967. (Appendix B, *infra*, p. 51.)

Upon respondent's petition to the Tax Court, that court, in a unanimous reviewed decision, upheld the deficiency asserted by the Commissioner, following recent decisions in the Court of Claims which had held that when a corporation issues its obligations

for or in lieu of its own previously outstanding preferred stock or bonds, no discount could arise from the issuance of those obligations if the amount received upon the issuance of the original securities was equal to the face amount of the obligations issued in exchange, and that the market value of the original securities at the time of the exchange was irrelevant. (Appendix A, *infra*, pp. 27-34.)

On respondent's appeal to the Court of Appeals for the Tenth Circuit, that court (2-1) reversed, refusing to follow the decisions of the Court of Claims because, as it stated, those decisions were based upon the unsound premise that a deduction for bond discount depended upon the taxpayer claiming such a deduction having suffered a loss in the transaction. (Appendix B, *infra*, pp. 54, 58, 64-65.) The court also assimilated the transaction here in question to the issuance of debentures for cash at a discount, followed by the use of the cash thus procured to retire outstanding preferred stock. (Appendix B, *infra*, pp. 53-54.) It further assimilated the transaction to a bonds-for-property transaction with regard to which there was a preexisting conflict of decisions. (Appendix B, *infra*, pp. 59-64.) The dissenting judge agreed with the majority that bond discount serves the same function as interest, but found that this did not provide any basis for disagreeing with the decisions of the Court of Claims; he rejected as inapplicable the analogies invoked by the majority.

REASONS FOR GRANTING THE WRIT

1. The decision of the Tenth Circuit is in direct and acknowledged conflict with the decisions of the Court of Claims in *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425, *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, modified, 433 F. 2d 1324, certiorari denied, 402 U.S. 944, and *St. Louis-San Francisco Railway Co.* v. *United States*, 444 F. 2d 1102, certiorari denied, 404 U.S. 1017.[1] It is also in conflict, though unacknowledged, with the decision of the Fifth Circuit in *Claussen's, Inc.* v. *United States*, 469 F. 2d 340. It is inconsistent, also, with the position of the Internal Revenue Service as set forth in Rev. Rul. 59-387, 1959-2 Cum. Bull. 56.

2. The question presented in this case is whether the respondent incurred bond discount—a cost of borrowing over and above stated interest—when it issued a 5% debenture in the face amount of $50 in substitution for a previously outstanding share of $50 par, 5% cumulative preferred stock. The Tax Court, following the decisions of the Court of Claims, held that discount could not arise in such a transaction when the face amount of the debentures was no

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[1] These decisions of the Court of Claims have been followed in all respects here relevant in several district court decisions still open for appeal: *Cities Service Co.* v. *United States*, 316 F. Supp. 61 (S.D. N.Y.), reaffirmed, 330 F. Supp. 421; *Gulf, Mobile & Ohio Railroad Co.* v. *United States*, 339 F. Supp. 489 (S.D. Ala.); *Texstar Corp.* v. *United States*, 73-1 U.S. T.C., par. 9105 (N.D. Tex.).

greater than the amount received by the corporation upon issuance of the preferred stock for which the debentures were substituted. The court of appeals, looking to the market value of the preferred stock at the time of the transaction, reversed the decision of the Tax Court, and held that discount, measured by the difference between the market value of the preferred stock and the face amount of the debentures issued in substitution, arose from the transaction.

The prototype transaction in which bond discount arises is one in which a corporation receives, for example, $950 upon the issuance of its bond in the face amount of $1,000, payable ten years after issuance. In such a case, the $50 difference between the amount received, or issue price, and the face amount of the bond is discount, deductible at the rate of $5 per year over the ten-year life of the bond.[2] Though the Internal Revenue Code and its predecessor Revenue Acts have never explicitly provided for the amortization and deduction of bond discount, Article 150 of Treasury Regulations 33 (1918 ed.) authorized such amortization and deduction, and all subsequent Treasury Regulations under the income tax statutes have done the same.[3] Under the 1954 Code, the provision first appeared as § 1.61-12(c)(3), Appendix D, *infra*, pp. 74-75. Since 1968, it has appeared, somewhat

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[2] Cf. Treasury Regulations on Income Tax (1954 Code), § 1.163-3(b)(1), Appendix D, *infra*, p. 76.

[3] The history of these Regulations is set forth in *Montana Power Co.* v. *United States*, 232 F. 2d 541, 546-548 (C.A. 3), certiorari denied, 352 U.S. 843.

more appropriately, as § 1.163-3(a) and (b), Appendix D, *infra*, pp. 75-76.[4]

Despite the remarks of the court of appeals, there is no issue in this case—unless it be a purely abstract and verbal issue of classification or usage[5]—concerning the nature of discount as "loss" or as "interest." The issue is whether the respondent incurred any added cost, over and above stated interest, for capi-

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[4] Section 61 sets forth the statutory definition of gross income. Section 163, Appendix D, *infra*, p. 72, authorizes a deduction for interest paid or accrued.

[5] It makes no practical difference in terms of a corporation's tax obligation whether discount be categorized as giving rise to loss or as giving rise to the payment of interest. As this Court pointed out in *Helvering* v. *Union Pacific Co.*, 293 U.S. 282, 284-285, the early Regulations spoke of discount in terms of loss sustained upon the payment of bonds at maturity, although they authorized amortization and deduction in anticipation of payment. The Court itself referred to discount both as "interest paid for the use of capital procured by a bond issue" and as "a loss resulting from the funding operation" (293 U.S., p. 286) within the same paragraph, and as "a loss to the taxpayer" and "part of the cost of the borrowed capital" within the same sentence (p. 287). More recently, the Court has been more explicit in referring to discount as interest. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57, 58, 66-67. As noted above, the current Regulations authorize the amortization and deduction of discount under Section 163, which allows the deduction of interest paid or accrued.

As a matter of fact, the Court of Claims, in both its *Erie Lackawanna* and its *Missouri Pacific* opinions, rather than basing its decisions upon the "unsound premise" of loss that the court below thought it perceived, expressly noted the variant references to discount as loss and as interest, stated the difference was irrelevant, and added that it would nonetheless treat discount as interest. See 422 F. 2d, pp. 427-428, fn. 7; 427 F. 2d, p. 730.

tal procured when it substituted its $50 debentures for the eliminated shares of $50 par preferred stock. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282, 284-287; *Old Mission Co.* v. *Helvering*, 293 U.S. 289, 292-293; *United States* v. *Midland-Ross Corp.*, 381 U.S. 54. As a matter of simple arithmetic, a corporation that issues a share of preferred stock for $50, then substitutes its $50 debenture for the share of preferred stock, and ultimately discharges the debenture for its $50 face amount, has obviously incurred no cost, other than the dividends on the preferred stock and the stated interest on the debenture, for the $50 of capital that it has procured and employed. Whether one categorizes discount as "loss" or as "interest," there can be no discount when there is no outlay, and no obligation to make an outlay, greater than the amount received. *Old Mission Co.* v. *Helvering*, *supra*, p. 292.

The court below sought to avoid the obvious fact that respondent was not obligated to pay more in discharge of its debentures than it had received for its preferred stock by assimilating the transaction to a sale of the debentures for $33 in cash, followed by the use of that cash to purchase and retire the preferred stock.* Appendix B, *infra*, pp. 53-54. But such

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* The record, based upon wholly stipulated facts, does not establish or indicate at what price respondent's debentures might have been sold in an arms-length transaction in 1957. The record does establish that there were restrictions upon respondent's power to purchase its preferred stock in 1957,

a contrary-to-fact analysis has been specifically rejected by this Court in determining the existence and amount of discount when a corporation substitutes one issue of its securities for another. *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543, 546-547. From the point of view of the corporation,[7] such a substitution constitutes a continuum, not two separate transactions. *Great Western Power Co.* v. *Commissioner, supra; Commissioner* v. *Capento Securities Corp.*, 140 F. 2d 382 (C.A. 1). Cf. *Chock Full O'Nuts Corp.* v. *United States*, 453 F. 2d 300

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while there were dividend arrearages. Appendix B, *infra*, pp. 44.

[7] The court below clearly misunderstood the Treasury's ruling with respect to the treatment of respondent's preferred shareholders whose preferred stock was eliminated, and who received debentures in substitution therefor. Appendix B, *infra*, pp. 48-49, 58. As Sections 354(a)(2) and 356(d) of the Internal Revenue Code provide and the ruling stated, shareholders who exchange shares of stock for corporate obligations in a recapitalization or other reorganization, will recognize gain or loss, if there is gain or loss. The amount of the gain or loss will be measured by the difference between the basis of the shares surrendered and the value of the obligations received. Sec. 1001(a). A shareholder who had bought a share of preferred stock for $50 and received a debenture worth $50 would therefore have zero gain, and not gain measured by the difference between $33 and $50, as the court below apparently understood. Appendix B, *infra*, p. 58. Such gain as might arise if the shareholder had a lower cost for his preferred stock than the value of the debentures received would presumably be capital gain. On the other hand, *if*, but only if, the transaction gave rise to amortizable discount to the corporation, as the court below held, *then* the recipient of the bond would be required by Section 1232(a) to report the amount of the discount as ordinary income. Cf. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54.

(C.A. 2); *AMF, Inc.* v. *United States*, 73-1 U.S.T.C., par. 9353 (Ct. Cl.); *Hunt Foods and Industries, Inc.* v. *Commissioner*, 57 T.C. 633, on appeal to C.A. 9.

The court below also sought to assimilate the transaction in this case to the issue of bonds for property, and to its recent decision in *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F. 2d 147, in which it had held that discount could arise on such a transaction. Appendix B, *infra*, pp. 59-64. There has been a long-standing conflict on this question.[8] On the one hand, it is held that, absent an explicit agreement otherwise, the face amount of bonds issued for property establishes the price paid for the property, so that no discount can have arisen. On the other, it is held that the market value of the property can be independently proven, and the difference between the market value of the property and the face amount of the bonds issued therefor will constitute discount. But when a corporation retires one issue of its securities and substitutes another issue therefor, it acquires no property. *United States* v.

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[8] The conflicting decisions with respect to bonds-for-property transactions are set forth and discussed in *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, 731-732, fn. 7 and 8 (Ct. Cl.).

The bonds with respect to which discount was claimed and allowed in the *Atchison, Topeka and Santa Fe* case were issued in a railroad reorganization in 1895, though the claimed deduction for discount involved the year 1950. Because the nature and terms of the reorganization were somewhat obscure, and because the decision turned at least in part (443 F. 2d, p. 152) upon the fact that the reorganization was a pre-1913 transaction, it did not appear appropriate to seek review by this Court.

Anderson, Clayton & Co., 350 U.S. 55. The point of departure for the conflict in the bonds-for-property cases is therefore absent in cases such as the present one, where one issue of securities is substituted for another. To assert that the *Atchison, Topeka and Santa Fe* decision was either controlling or of guiding relevance in this case was either, at best, to beg the question in this case, or, as we believe, to invoke a decision of little or no relevance.

3. Though we believe it clear and obvious that no discount can arise where a share of preferred stock is issued for $50, where the preferred stock is thereafter cancelled, and an obligation for $50 is issued in its stead, and though this case can be disposed of on that basis, the Fifth Circuit's decision of the immediately related issue in *Claussen's, Inc.* v. *United States*, 469 F. 2d 340, gives added support to our conclusion.

While the Court of Claims and the district court decisions referred to in footnote 1, *supra*, have agreed that the amount received for the original securities constitutes a floor below which no claim for discount can be allowed upon the issuance of corporate obligations in substitution for the original securities, they have drawn a negative inference to the effect that discount may arise if the face amount of the obligations issued in substitution is greater than the amount originally received for the first securities, and have stated that in such circumstances discount will be measured by the difference between the value to the corporation of the securities eliminated

and the face amount of the obligations issued in substitution. This was originally set forth in *Cities Service Co.* v. *United States*, 316 F. Supp. 61 (S.D. N.Y.), and accepted by the Court of Claims in its *Missouri Pacific* and *St. Louis-San Francisco* decisions, *supra*.

The Fifth Circuit's *Claussen's* decision has rejected, correctly, we believe, the idea that discount may arise from the substitution of one issue of securities for another, where there is no new borrowing—no procurement of new capital. In that case the taxpayer-corporation issued 6% debentures in the aggregate face amount of $2,250,000, plus new common stock and stock purchase warrants, for previously outstanding common stock. An aggregate of $1,962,-500 had been received by the corporation upon issuance of the original common stock, and that amount thereafter constituted the capital and paid-in surplus of the corporation. That amount was also found to be the value of the outstanding common stock at the time of the exchange. The court of appeals denied the claim that the $362,500 difference constituted bond discount, pointing out that the corporation had acquired no new capital and that the shareholders had surrendered nothing to the corporation for which there could be a cost of borrowing. It noted that in a slightly different context an issue of bonds and stock for previously outstanding stock had been held to give rise to a dividend. *Bazley* v. *Commissioner*, 331 U.S. 737. Cf. Sec. 356(a)(2) and (d), Internal Revenue Code of 1954.

It is clear that if a corporation retires a share of preferred stock issued at $100 for a call price of $105, or a share of common stock for a price greater than the issue price, the corporation does not obtain thereby a deduction from gross income. Sec. 311(a), Internal Revenue Code of 1954. If, instead of paying cash for the retirement of the stock, it issues its obligation for the same amount payable in the future, there is no reason why it should be permitted to deduct as discount what it could not deduct if it had paid cash, whatever may prove to have been the market value of the stock at the time of retirement. There may be many reasons (including, for example, a compulsory sinking fund) why a corporation may be led to pay more than could be established as market value in order to retire shares of stock. And the deferral of the payment is no indication of discount. Unless it can be established other than through evidence of market value that the corporation was paying for the privilege of deferral (as might possibly be the case where the deferred obligation was non-interest-bearing) there is no basis for discount.

As we have stated, there is not present in this case the factual basis for the negative inference accepted by the Court of Claims and the district courts where obligations are issued in face amount greater than was received for the original securities. But the Fifth Circuit's *Claussen's* decision demonstrates, even when that added element did exist, the irrelevance, or extremely limtied relevance, of the market value of

shares of stock for which corporate obligations are substituted.

4. The administrative importance of the question here involved is great, and in view of the conflict of decisions the question can be resolved only by this Court. Though Section 1232(b) of the Internal Revenue Code, Appendix D, *infra*, pp. 72-74, as amended by Section 413 of the Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, may have disposed of this and related questions with respect to subsequent issues of corporate obligations, it is applicable only to bonds issued after May 27, 1969.

Meanwhile, as we are informed by the Internal Revenue Service, there are outstanding billions of dollars of long-term bonds that were issued in substitution or exchange for other securities in the course of railroad reorganizations alone. Claims for discount will be potential and recurrent during the many years that these bonds will remain outstanding. It may be recalled that the claim for discount in the *Atchison, Topeka and Santa Fe* case was first made for 1950, though the bonds had been issued in 1895. In addition, there have been similar bond issues presenting the same questions with relation to the reorganization of public utility holding companies. See, *e.g., Cities Service Co.* v. *United States supra.* There are also, in numbers difficult to estimate, outstanding bonds resulting from voluntary reorganizations or recapitalizations such as those involved in this case and in the *Claussen's* case. One of the factors leading to the 1969 legislation was the widespread

use of bonds in conglomerate acquisitions. Though these latter may involve more bonds-for-property transactions than substitutions for preexisting securities, the Internal Revenue Service anticipates a variety of bond discount problems arising from the surge of conglomerate acquisitions prior to 1969.

The amounts involved in bond discount issues are characteristically large, and will be recurrent far into the future, as is evident from the reported decisions alone. Gulf, Mobile & Ohio Railroad Company has claimed bond discount of nearly $5,200,000 on the issuance of 100-year debentures in the face amount of $12,653,000 in 1958 for preferred stock with an asserted market value of $7,465,000. Missouri Pacific Railroad Company claimed bond discount of $76,965,000 on its issuance in 1956 of 90-year debentures in the face amount of $529,117,000 for its bonds and its subsidiaries' bonds and stock. St. Louis-San Francisco Railway Company claimed bond discount of $29,068,000 on issuance of $120,935,000 of bonds in a 1947 reorganization, and additional discount of $10,220,000 on issuance of $33,129,000 of debentures in a recapitalization in 1956. Other claims for bond discount that have been presented to the Internal Revenue Service have involved, as we are informed, even larger amounts.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

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JUNE 1973.

APPENDIX A

57 T. C. No. 6

UNITED STATES TAX COURT

Docket No. 1081-70

Filed October 14, 1971

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petitioner, a corporation with its principal office at the time the petition in this case was filed in Shawnee Mission, Kansas, in July 1957, pursuant to a resolution providing for a reorganization and recapitalization, issued its debenture bonds of a face amount of $50 in exchange for its preferred stock of a par value of $50 and canceled the preferred stock received in the exchange. At the date of the exchange the preferred stock was quoted on the "over-the-counter" market at prices averaging around $33 per share. Petitioner, for its fiscal years ended April 30, 1958, through April 30, 1967, is not entitled to deductions for amortizable debt discount and therefore respondent correctly disallowed this claimed deduction for its fiscal year 1967 (here in issue) and for its prior fiscal years for computation of loss carryovers. *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F. 2d 147 (C.A. 10, 1971), distinguished.

Charles W. Hess and *James J. Melching*, for the petitioner.

David A. Pierce, for the respondent.

OPINION

SCOTT, *Judge*: Respondent determined a deficiency in petitioner's income tax for the fiscal year ended April 30, 1967, in the amount of $147,949.76.

The issue for decision is whether petitioner is entitled to a deduction for amortizable debt discount measured by the difference between the face value of its corporate bonds and the fair market value of its preferred stock which it received in exchange for the bonds.

All of the facts have been stipulated and are found accordingly.

National Alfalfa Dehydrating and Milling Company (hereinafter referred to as petitioner or National Alfalfa) is a Delaware corporation with its principal office at the time the petition in this case was filed in Shawnee Mission, Kansas.

National Alfalfa filed its Federal corporate income tax return for the fiscal year ended April 30, 1967, with the district director of internal revenue, Wichita, Kansas.

National Alfalfa was incorporated on May 4, 1946, to engage in the business of dehydrating and milling alfalfa.

Prior to July 23, 1957, it had 47,059 shares of its $50 par value cumulative preferred stock issued and outstanding. The dividend arrearages on each of these shares of preferred stock amounted to $10 as of July 23, 1957.

Petitioner's certificate of incorporation and the preferred stock certificates provided that the preferred stock was redeemable at stated prices depending on the redemption date. After December 1, 1955 the redemption price was $51.

On April 8, 1957, the board of directors of National Alfalfa passed a resolution which authorized $2,352,950 in 5 percent sinking fund debenture bonds to be issued by the corporation in exchange for its outstanding preferred stock and the increase in the par value of its common stock from $1 to $3 a share.[1]

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[1] This resolution provided as follows with respect to the exchange of bonds for preferred stock:

> RESOLVED, that the President or Vice-President and the Secretary or Assistant Secretary of the Company be and they are hereby authorized to enter into a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, dated, as of July 1, 1957, pursuant to the terms of which there shall be issued $2,352,950.00 principal amount 5% Debentures, due July 1, 1975, which said bonds shall be issued in exchange for shares of the 5% Cumulative Preferred Stock on the basis of $50.00 principal amount of such debentures for each share of preferred stock and that this resolution, when ratified by the shareholders shall constitute authority for said issue, and
>
> RESOLVED, that the Company be authorized to issue warrants for the purchase of the common stock of the Company to each preferred shareholder participating in the exchange of his preferred stock for Debentures of the Company in the reorganization effective August 1, 1957, on the basis of one warrant for each share of Preferred Stock surrendered, said warrants to evidence the right to purchase one-half (½) share of common stock and said warrants to be exerciseable to purchase only full shares of common stock of the Company at a price of $10.00 per share at any time from the date of issue until July 1, 1969 or so long as any debenture bonds re-

The principal business purpose for the 1957 exchange of debentures for preferred stock was to enable National Alfalfa to expand its eastern producing areas. In order to expand into the eastern areas National Alfalfa's credit requirements for carrying inventory were increased by 50 percent. To improve National Alfalfa's credit status this transaction also included the issuance of certain warrants to the cumulative preferred shareholders which permitted the holder to purchase common stock of National Alfalfa at a stated price in order to eliminate the dividend arrearages owed to them. In addition, the cancellation of the preferred stock and elimination of the dividend arrearages, made it possible for National Alfalfa to declare dividends to the common stockholders thereafter.

An indenture dated July 1, 1957, was arranged between National Alfalfa and Fidelity-Philadelphia

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main outstanding, after which date warrants will become void, and

* * * *

RESOLVED, that this resolution and the reorganization and recapitalization contemplated hereby be submitted to a vote of the shareholders, and if adopted by the requisite number of shareholders, all rights and privileges of the 5% Cumulative Preferred Shares heretofore expressed or inherent in the ownership of said Preferred Stock shall cease and determine as of August 1, 1957 except such right to surrender the said shares of stock on the terms herein contained except as otherwise provided by law, and

RESOLVED, that the officers of the Company be hereby authorized to submit the Plan of Reorganization to the Commissioner of Internal Revenue in an attempt to have the said Plan qualified as a tax free reorganization under the Internal Revenue Code of 1954, and

* * * *

Trust Company, as trustee. On behalf of National Alfalfa, Fidelity-Philadelphia Trust Company requested a ruling from the United States Treasury Department. In reply to this request a letter ruling dated May 29, 1957, was issued. This letter stated that no gain or loss would be recognized on the exchange of the $1 par value common stock for $3 par value common stock under the provisions of sections 368(a)(1)(E)[2] and 354(a) but gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for debenture bonds.[3]

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[2] All references are to the Internal Revenue Code of 1954 unless otherwise indicated.

[3] The letter ruling stated as follows:

(1) The exchange by the holders of $1. par value common stock for $3. par value common stock, on the basis described above, will constitute a recapitalization and, therefore, a reorganization, within the meaning of section 368(a)(1)(E), of the Internal Revenue Code of 1954. No gain or loss will be recognized to Company as a result of the exchanges.

(2) No gain or loss will be recognized to the holders of common stock as a result of the exchange of common stock (section 354(a)). The basis to each stockholder of the stock received will be the same as the cost or other adjusted basis of the stock surrendered (section 358(a)). The holding period of the stock received will include the holding period of the stock surrendered in the exchange (section 1223).

(3) Assuming but not determining that the 5% debenture bonds to be issued qualify as securities (create a genuine relationship of debtor and creditor), gain or loss will be recognized to the preferred stockholders from the exchange of 5% cumulative preferred stock, par $50., and the dividend arrearage thereon of $10. per share as of June 1, 1957, for debenture bonds and warrants to subscribe for the new common stock at

On July 23, 1957, the holders of cumulative preferred stock of National Alfalfa exchanged that stock for the debenture bonds of National Alfalfa due in 1975. Each unit of the debenture had a fixed maturity value of $50.

The preferred stock received by National Alfalfa in exchange for the debentures was retired and canceled upon the issuance of the bond indebtedness by an entry on National Alfalfa's books debiting preferred stock for $2,352,950 thereby completely eliminating the preferred stock account and crediting the liability account for 18-year 5 percent debentures for the same amount.

$10. per share (section 302(a)). The gain or loss recognized from the exchange will be measured by the difference between the cost or other adjusted basis of the preferred stock surrendered and the fair market values of the debentures and warrants received and such gain or loss will constitute capital gain or loss subject to the applicable provisions and limitations of Subchapter P Part I of Subtitle A of the Code.

The basis of the debentures and the warrants received by the holders of the old preferred stock will be the fair market values used in the determination of the recognizable gain or loss.

(4) The fair market values prevailing on the date the Plan is declared effective are the values to be assigned to the debentures and the warrants received in the exchange.

The preferred stock of National Alfalfa was quoted in the Over-The-Counter Market during the period July 15 to July 30, 1957 as follows:

Date	Bid	Offer	Date	Bid	Offer
July 15	33	35	July 23	32	34
July 16	32	35	July 24	32	35
July 17	32	34	July 25	29	32
July 18	31	34	July 26	30	33
July 19	32	34	July 29	30	33
July 22	31	33	July 30	30	33

The National Stock Summary dated October 1, 1957 shows 100 shares of National Alfalfa wanted on July 9, 1957 at $32 and 100 shares wanted on July 10, 1957 at $33 and 100 shares offered on July 10, 1957 at $35.

On its Federal income tax returns for its fiscal years ended April 30, 1958 through April 30, 1967, National Alfalfa claimed deductions for debt discount expense and in computing the amount of the claimed deduction used a fair market value of $33 per share for the preferred stock exchanged for the bonds. The difference of $800,003 between the face value of the debentures ($2,352,950) and the fair market value of the preferred stock (47,059 shares times $33 per share) ($1,552,947) was amortized over the years 1957 through 1975 and appropriate amounts were taken as deductions each year through April 30, 1967.

The deduction claimed by National Alfalfa each year for debt discount was computed on the basis of the total of two different variables:

1. The unamortized discount of bonds redeemed or repurchased and retired by National Alfalfa in the year of the deduction, and
2. The annual straight line amortization on those bonds still outstanding at the end of the year.

The amounts of deduction for discount taken by National Alfalfa on its Federal income tax returns for its fiscal years ended April 30, 1958 through April 30, 1967 are as follows:

Year ended April 30	Unamortized discount on bonds currently repurchased or redeemed	Straight-line amortization	Total
1958	- 0 -	$37,037.00	$ 37,037.00
1959	$20,104.00	43,273.00	63,377.00
1960	17,007.00	42,310.00	59,317.00
1961	- 0 -	28,743.00	28,743.00
1962	14,062.00	27,751.00	41,813.00
1963	- 0 -	27,751.00	27,751.00
1964	26,624.00	25,562.00	52,186.00
1965	37,903.00	22,168.00	60,071.00
1966	4,139.00	21,761.00	25,900.00
1967	98,824.00	10,980.00	109,804.00
			$505,999.00

As required by the indenture a sinking fund was established in order to secure funds to redeem the debenture bonds. In lieu of making all or any part of the sinking fund payments in cash National Alfalfa is also authorized by the terms of the indenture

in Article VI to deliver outstanding debentures to the sinking fund trustee which have either been redeemed or purchased by National Alfalfa on the open market.

National Alfalfa has at all times been on schedule following the provisions of the sinking fund and is not now nor has at any time pertinent hereto been in default of any of the terms of the indenture. As of April 30, 1967, only 11,626 of the original 47,059 debenture bonds of National Alfalfa remained outstanding, as a result of the sinking fund trustee and National Alfalfa having redeemed or otherwise repurchased and retired the other 35,433 debentures.

Respondent in his notice of deficiency disallowed petitioner's claimed deduction of $109,804 for amortization of bond discount for its fiscal year ended April 30, 1967, and also disallowed $321,657 of claimed loss carryovers from prior years based on the disallowance of petitioner's claimed deductions for amortization of bond discount for its fiscal years ended April 30, 1958, through April 30, 1966.

Petitioner contends that since the maturity value of its debenture bonds issued in exchange for its preferred stock was in excess of the fair market value of the preferred stock it received, the difference is discount which may be prorated or amortized over the life of the bonds and deducted under section 163.

Respondent's position is that the transaction in which petitioner exchanged the bonds for preferred stock was a tax free recapitalization under section 368(a)(1)(E) in which gain or loss is not recognized. Respondent argues that the difference in the face amount of the bonds and the fair market value of the stock is nonrecognizable loss. Respondent also argues that petitioner's issuance of bonds for its own

preferred stock was a redemption of the preferred shares and that under the provisions of section 311 (a) (2), no gain or loss shall be recognized by a corporation on such a distribution. Finally, respondent contends that in any event no bond discount arises when a taxpayer issues its bond in exchange for its stock of a par value equal to the face value of the bond and then cancels the stock.

It is well established that debt discount arising from the issuance of bonds or debt obligations at a price below their par or maturity value is deductible. Respondent's regulations providing that the deduction for bond discount is to be prorated over the life of the bonds [4] has been recognized as valid. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282 (1934). However, there is a division of authority with respect to the question of whether original issue discount can arise where bonds are issued for something other than cash.[5]

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[4] Sec. 1.163-3, Income Tax Regs. (T.D. 6984 filed 12-23-68, (1969-1 C.B. 39) Deduction for bond discount.

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b) (2) of sec. 1.1232-3).

Sec. 1.163-3(d) replaced Reg. sec. 1.61-12(c) which as in effect in 1967 and for many years prior thereto provided in part:

> if bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

[5] See footnote 8 *infra*.

Respondent's arguments based on section 368(a)(1)(E) and section 311(a)(2) need not be discussed since we are disposing of this case in his favor on another issue.

The major contention of respondent is that in a transaction where a corporation exchanges its bonds for its stock which it then cancels, no bond discount arises. Respondent argues that petitioner did not issue its bonds for "property" but rather merely replaced its paid-in capital represented by its preferred stock by paid-in capital represented by its bonds. Respondent relies on *Erie Lackawanna Railroad Company* v. *United States*, 422 F. 2d 425 (Ct. Cls., 1970) and *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727 (Ct. Cls., 1970), modified on rehearing 433 F. 2d 1324 (Ct. Cls., 1970), in support of his position. Petitioner attempts to distinguish *Missouri Pacific Railroad Co.* v. *United States*, *supra*, from the present case on its facts. In the *Missouri Pacific* case, bonds of a reorganized company were exchanged for bonds of that company and stocks and bonds of a subsidiary. The Court held that no debt discount arose where the old bonds and stocks and bonds of the subsidiary received in the exchange were equal in face amount to the new bonds issued. Petitioner contends there was no "qualitative" difference in the securities exchanged in the *Missouri Pacific* case whereas in the instant case there is a "qualitative" difference in the bonds issued by petitioner and the preferred stock exchanged for those bonds. Petitioner does not contend that the facts in *Erie Lackawanna Railroad Company* v. *United States*, *supra*, which held that no debt discount arose on the issuance of the taxpayer's bonds for stock in equal face amounts are distinguishable from the facts in the instant case but

argues that the conclusion in that case that the issue price of the stock rather than its market value is the amount to be used in determining whether discount has arisen on the exchange of the bonds for the stock is without a rational basis.*

In our view there is no distinction in substance between the facts in either the *Erie Lackawanna* case or the part of the *Missouri Pacific* case dealing with the exchange of bonds of the new company for bonds of the old company and the instant case. In the *Erie Lackawanna* case when the taxpayer exchanged its $100 debenture bonds for its preferred stock with a par value of $100 and canceled the stock received in the exchange, the fair market value of the stock was less than $100. In holding that the "amount paid for the preferred stock should be considered as the cost of the bond" the Court stated that since the taxpayer had originally received $100 for the preferred stock, it was not "hurt" as a result of the transaction. The Court in the *Missouri Pacific* case extended its holding in *Erie Lackawanna* to cover a bonds-for-bonds

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*We have not discussed petitioner's "what might have been" argument. This argument by petitioner in effect is that if it had issued the bonds for $33 in cash and used the $33 to purchase its outstanding preferred stock, the net result would be the same as an exchange of the bonds for the stock, but there would be no question that it would be entitled to deductions for amortizable bond discount. The simple answer to this contention is that it is not what happened. However, the assumption is not based on any evidence in this case. There is no evidence in this case to show at what price the bonds might have been sold on the open market had they been issued and put up for sale for cash. Also, there is no evidence to indicate that petitioner would have been able to purchase all of its preferred stock on the open market or at what price that quantity of stock could have been purchased other than the $51 at which it could be redeemed.

exchange and bonds exchanged for stock and bonds of a subsidiary. In that case the Court held bond discount to be available where the amount originally paid for bonds was less than the face amount of the bonds issued by the taxpayer in the exchange.[7] Again, the Court looked to the payment received by the taxpayer when the original stocks or bonds were issued to determine whether debt discount arose. In both *Erie Lackawanna* and *Missouri Pacific*, the Court noted that it was not considering the general question of whether debt discount can arise in transactions in which bonds are issued for property.[8] We

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[7] In the case of certain stock which had an issue price less than the face amount of the bonds but a worth greater than such issue price, the Court held on rehearing that no bond discount arose from the transaction. In its opinion on the motion for rehearing the Court held the face amount of the stock to be the "floor" but not the "ceiling" in calculating whether the bonds issued for the stock were issued at a discount.

[8] In *Erie Lackawanna Railroad Company* v. *United States*, 422 F. 2d 425, 430-431 (Ct. Cls., 1970), the following statement was made as to this question:

> In addition, we have failed to consider the conflict of whether debt discount can arise in instances where bonds are issued for property. Since we feel that, in the bond discount area, a corporation's own stock comprises a category completely separate from cash and other types of property, we have found it unnecessary and indeed unwise to involve ourselves, at this time, in this rather sticky issue. *Compare* Nassau Lens Co. v. Commissioner, *supra*; American Smelting & Ref. Co. v. United States, *supra*; Industrial Dev. Corp. v. United States, *supra*; *with* Southern Natural Gas Co. v. United States, supra; Montana Power Co. v. United States, 159 F. Supp. 593, 141 Ct. Cl. 620, cert. denied, 358 U.S. 842, 79 S.Ct. 28, 3 L.Ed. 2d 76 (1958); Montana Power Co. v. United States, 232 F. 2d 541 (3d Cir.), cert. denied, 352 U.S. 843, 77 S.Ct. 51, 1 L.Ed.2d 59 (1956) (dictum). Instead, we feel

that the problem can be better resolved when a case arises in which bonds are exchanged for property other than the stock of the issuing corporation.

In *Missouri Pacific Railroad Company* v. *United States*, 427 F. 2d 727, 731 [footnote 7] (Ct. Cls., 1970), the conflict of authority on this issue was discussed as follows:

7. We do not mean to imply by this statement that we are now holding that debt discount is available where bonds are issued for property (other than the corporation's own securities). In fact there appears to be a definite split of authority on this question with Nassau Lens Co. v. Commissioner of Internal Revenue, 308 F. 2d 39 (2d Cir. 1962), and American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3d Cir. 1942), holding that debt discount is available where bonds are issued for property, and Southern Natural Gas Co. v. United States, 412 F.2d 1222, 188 Ct.Cl. 302 (1969), Montana Power Co. v. United States, 159 F. Supp. 593, 141 Ct.Cl. 620, cert. denied 358 U.S. 842, 79 S.Ct. 23, 3 L.Ed. 2d 76 (1958), and Montana Power Co. v. United States, 232 F.2d 541 (3d Cir.), cert. denied 352 U.S. 843, 77 S.Ct. 51, 1 L.Ed.2d 59 (1956) (dictum), stating that debt discount is not so available. We are simply saying that, as between the situation where a corporation issues bonds for its own securities and where a corporation issues bonds for other types of property, we can better understand how fair market value could be applied to the latter situation but not to the former—assuming, for the moment, that debt discount would be available in the latter situation.

Sec. 1232(b)(2) defining issue price of bonds was amended by sec. 413(b) of the Tax Reform Act of 1969, P.L. 91-172 "in order to clarify the situations in which original issue discount may arise * * *." S. Rept. No. 91-552, 91st Cong., 1st Sess. (1969) 1969-3 C.B. 517. This provision is made applicable to bonds issued after May 27, 1969, other than those issued pursuant to a written commitment binding on May 27, 1968, and at all times thereafter. Sec. 413(e) P.L. 91-172.

Sec. 1232(b)(2) as amended by the 1969 Tax Reform Act

are impressed with the reasoning of the Court in *Erie Lackawanna* and *Missouri Pacific*. The rationale of our holdings in *375 Park Avenue Corporation*, 23 B.T.A. 969 (1931), and *Liquid Carbonic Corporation*, 34 B.T.A. 1191, 1196 (1936), and cases there cited,

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applicable to bonds issued after May 27, 1969 (sec. 413 of P.L. 91-172) provides in part:

> In the case of a bond or other evidence of indebtedness or an investment unit as described in this paragraph *(other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1)* or an insolvency reorganization within the meaning of section 371, 373 or 374), which is issued for property and which—
>
> (A) is part of an issue a portion of which is traded on an established securities market, or
>
> (B) is issued for stock or securities which are traded on an established securities market,
>
> the issue price of such bond or other evidence of indebtedness * * * shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness * * * which is issued for property (other than money) shall be the stated redemption price at maturity. [Underscoring supplied.]

This provision is, of course, not applicable to the instant case. If it were applicable, respondent's argument under sec. 368(a)(1)(E) would have relevance whether bond discount is considered to be deductible as interest or as loss and we would dispose of the case by determining that the bonds were issued pursuant to a plan of reorganization under sec. 368(a)(1)(E) even though the exchange was not one in which there was nonrecognition of gain or loss.

Respondent in his reply brief states that in the instant case he is not contending that bond discount can never arise where bonds are issued for property but only that no such discount arises under the facts of this case.

support the reasoning in those Court of Claims' cases. In the *375 Park Avenue* and *Liquid Carbonic* cases, we concluded that where bonds were retired by a corporation by issuance of its stock, the transaction did not amount to "payment" of the bonds so as to entitle the corporation to deduct unamortized bond discount and that no loss to the corporation resulted from the transaction. The instant case, as well as the *Erie Lackawanna* and *Missouri Pacific* cases, is obviously actually distinguishable from the *375 Park Avenue* and *Liquid Carbonic* cases. However, the same reasoning that supports the conclusion that retiring a bond by issuing stock for it is not equivalent to payment of the bond in cash or property other than stock of the corporation retiring the bond also supports the conclusion that a bond issued for a corporation's own preferred stock, par for par, has not been issued at a discount. The payment received by the corporation for the bond is the amount originally paid in for the stock. The transaction from the corporation's standpoint is merely the exchange of one form of interest in the corporation for another. We recognize, as petitioner contends, that petitioner was not obligated to pay back to its preferred stockholders the $50 they had paid in for the stock except upon redemption of the stock or liquidation of the company and that upon liquidation the payment would be subordinate to the payment to creditors of the corporation. These facts may affect the value of the stock as compared to the bond but they do not affect the amount paid to the corporation for the bond. The stock had no "value" to petitioner aside from the $50 it had originally received for it. This is the rationale of the *Erie Lackawanna* and *Missouri Pacific* cases. Bonds issued in

exchange for stock or bonds of the issuing company are distinguishable from bonds issued for a type of property which was never represented by a previous cash payment to the issuing company and which is retained by the issuing company.[9] After the transaction here involved, which included the issuance of the bonds and the cancellation of the stock, was completed petitioner had no "property" paid for its bonds unless the $50 paid in for the stock is the property paid in for the bonds.

Since we agree with the conclusions in the *Erie Lackawanna* and *Missouri Pacific* cases, and those conclusions are in effect supported by our decisions in *375 Park Avenue Corporation, supra*, and *Liquid Carbonic Corporation, supra*, we would without further discussion apply that reasoning in the instant case and hold that petitioner's bonds were not issued at a discount, except for the recent decision of the United States Court of Appeals for the Tenth Circuit to which an appeal in this case would lie, in *Atchison Topeka & Santa Fe R. Co.* v. *Commissioner*, 443 F. 2d 147 (C.A. 10, 1971). The *Atchison Topeka & Santa Fe* case involved a deduction for bond discount claimed by the taxpayer for the year 1950 on its 100-year debenture bonds issued in 1895. The bonds had been issued in a reorganization, the face amount of the new bonds being equal to the face amount of old bonds which were surrendered as a part of the reorganization but greater than the fair market value of the old bonds. The Government contended that the bonds of the taxpayer (the new company in the reorganization) were issued in partial payment for

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[9] See footnote 8 for similar comments in the *Missouri Pacific* case.

the physical properties of the old company in the amount of the purchase price of the assets for which issued and therefore no discount was incurred. The Court held that the sale of the assets for the bonds was merely one step in a reorganization and affirmed the holding of the lower court that the taxpayer's bonds had been issued in exchange for bonds of the old company. In the alternative the Government contended that even assuming the bonds of the taxpayer were exchanged for the bonds of the old company, no discount arose "because none may be imputed where discount is not specified in a bonds-for-property exchange." The Court rejected the Government's contention and concluded that since the face amount of the bonds issued by the taxpayer exceeded the fair market value of the old bonds for which they were exchanged, "economic and business reality" conforms with the view that to the issuer bond interest is reflected both in the stated rate of interest and by the amount below par received by the issuer when the bonds are distributed. The Court in reaching its conclusion cited the *Missouri Pacific* case and the *Erie Lackawanna* case in a footnote but did not discuss either of those cases. The Court's discussion of the issue of whether bond discount might arise when a company exchanged new bonds for old bonds in a reorganization consisted of the following paragraph (443 F. 2d at 152-153):

> Perhaps the strongest authority the Government cites for its argument that discount may not arise in a bonds-for-property transaction is the analysis in an opinion by Judge Kalodner, joined by Judge Staley, in *Montana Power Co.* v. *United States* [56-1 USTC par. 9402], 232 F. 2d 541, 545 (3rd Cir. 1956), in which the

other five members of the Court sitting *en banc* did not join. Upon reviewing the history and rationale of the Regulation authorizing the deduction for bond discount and cases considering the Regulation, Judge Kalodner concluded that the Regulation was never intended to be applicable in a bonds-for-property transaction. The position expressed by Judge Kalodner was adopted by the Court of Claims in *Montana Power Co.* v. *United States* [58-1 USTC par. 9332], 159 F. Supp. 593 (1958).[5] However, the contrary view of Judge Goodrich in *American Smelting & Refining Co.* v. *United States* [42-2 USTC par. 9670], 130 F. 2d 883, 885 (3rd Cir. 1942) is more persuasive: "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash." *Accord, Nassau Lens Co.* v. *United States* [62-2 USTC par. 9723], 308 F. 2d 39, 44 (2nd Cir. 1962); *Industrial Development Corp.* v. *United States* [56 USTC par. 10,066), 51 A.F.T.R. 1514 (N.D. Ill. 1966); *Southern Fertilizer & Chem. Co.* v. *Edwards* [55-1 USTC par. 49,133], 167 F. Supp. 879 (M.D. Ga. 1955). [Footnote omitted.]

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[5] But compare *Erie Lackawanna R. R.* v. *United States* [70-1 USTC par. 9245], 422 F. 2d 425, 430 (Ct. Cl. 1970) and *Missouri Pacific R. R.* v. *United States* [70-1 USTC par. 9457], 427 F. 2d 727, 731 (Ct. Cl. 1970).

Respondent attempts to distinguish the *Atchison, Topeka & Santa Fe* case from the instant case on its facts, primarily by the statements that (1) "The Court is a bit ambivalent as to whether the 'new' company issued its bonds for the bonds of the old

company or for the property of the old company" and (2) "What the 'new' company received for its stock and debentures was the assets of the old company, including the newly invested capital, subject to the liabilities which resulted from the negotiations."

Respondent follows his statements by an argument that the *Atchison, Topeka & Santa Fe* case involved an entity purchasing the assets of another corporation which purchased the bonds to merge them with the assets of the old company because the bonds were liens on those assets. Respondent contends that these facts distinguish the *Atchison, Topeka & Santa Fe* case from the instant case.

Finally, respondent argues that the decision in the *Atchison, Topeka & Santa Fe* case if not factually distinguishable from this case, is invalid.

The Court in *Atchison, Topeka & Santa Fe* stated the Government's first argument to be "that as a matter of law taxpayer's bonds were issued in partial payment of the negotiated and agreed purchase price for the assets of the old company, in substance as well as in fact, and therefore no discount was incurred." The Court rejected this argument of the Government before discussing the Government's alternative argument. The Tenth Circuit's rejection of this contention of the Government must be viewed in the light of the statements made by the trial court to the jury when the case was submitted to the jury by the District Court. [*The Atchison, Topeka and Santa Fe Railway Company, a corporation* v. *United States*, an unreported case (D. Kans. 1969, 69-2 USTC par. 9740; 24 A.F.T.R. 2d 69-5963].[10]

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[10] The following are excerpts from the trial court's charge to the jury in *The Atchison, Topeka and Santa Fe Railway Company, a corporation* v. *United States*, an unreported case

(D. Kans. 1969, 69-2 USTC par. 9740; 24 A.F.T.R. 2d 69-5963):

> The Court has held as a matter of law that the one hundred year general and adjustment mortgage bonds issued in 1895 by the plaintiff (Atchison, Topeka and Santa Fe Railway Company), were exchanged for the general mortgage bonds issued by the "old company" (Atchison, Topeka and Santa Fe Railroad Company). It is for you, the jury, to determine as a matter of fact (1) whether the exchange of the bonds of the Railway Company (referred to as "the new bonds") for those of the Railroad Company (the old bonds) give rise to a discount; and (2) the amount of such discount.
>
> So the factual issues remaining for you to decide in this case are:
>
> 1. What was the fair market value of the old company's bonds which plaintiff received in exchange for its general and adjustment mortgage bonds?
>
> 2. If the fair market value of the bonds received was less than the principal amount of said bonds, that is, less than $147,620,250, was all or any part of the difference discount?
>
> * * * *
>
> There is no burden upon the government to prove that it is correct in retaining the taxes paid by the plaintiff with its income tax return. Rather, the burden is upon the plaintiff to establish by a preponderance of the evidence that the fair market value of the old general mortgage bonds was less than the par value of the new general and adjustment mortgage bonds. Plaintiff must also establish by a preponderance of the evidence that such a difference, or any part of such difference, was discount. In order to do this, plaintiff must show by a preponderance of the evidence that its general and adjustment mortgage bonds were issued under circumstances which would be equivalent of a discount. In other words, that the circumstances surrounding the issuance of its bonds were typical of the circumstances that might compel a corporation to discount its bonds.
>
> * * * *

The distinction in the *Atchison, Topeka & Santa Fe* case and the instant case is that in the former no argument was presented by the Government or considered by the Court as to whether in fact the "property" received by the new company for its bonds was the "bonds of the old company at their fair market value" or the money originally paid for those bonds. For this reason the *Atchison, Topeka & Santa Fe* case is as a matter of law distinguishable from the instant case, the *Erie Lackawanna* case, and the *Missouri Pacific* case. We will not speculate on what conclusion the Tenth Circuit would have reached in *Atchison, Topeka & Santa Fe*, had the issue presented to it been issuance of new bonds for old bonds of the same company as distinguished from issuance of bonds for other property. The case of *American Smelting and Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3, 1942), was the only case discussed by the Court in *Atchison, Topeka & Santa Fe* which involved an exchange of bonds for stock or securities. That case involved bonds exchanged for stock of a subsidiary which the Court deciding that case considered to be the same as any other property. Because the issue presented to us differs from the legal issues presented to and decided by the Tenth Circuit in the *Atchison, Topeka & Santa Fe* case, we do not consider our holding in *Jack E. Golsen*, 54 T.C. 742 (1970), affirmed —— F. 2d —— (C.A. 10, June 18, 1971), to require us to hold for petitioner in the instant case on the basis of the decision of the Tenth Circuit in the *Atchison, Topeka & Santa Fe* case. In *Jack E. Golsen* (54 T.C. at 757), we held that we are required to "follow a Court of Appeals' decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that

court alone." For the reasons we have heretofore discussed we do not consider the decision of the Tenth Circuit in *Atchison, Topeka & Santa Fe* to be "squarely in point" with the instant case.[11]

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[11] If we attempted to follow precisely the holding of the Tenth Circuit in *Atchison, Topeka & Santa Fe*, even though that holding was arrived at without consideration of one of the primary issues presented in the instant case, it would not follow that we would conclude that petitioner's bonds were issued at a discount of $17 a bond, for which discount petitioner contends. In the *Atchison, Topeka & Santa Fe* case the questions of the fair market value of the old company's bonds which the taxpayer received in exchange for its bonds, and if the fair market value of the old bonds was less than the principal amount of the new bonds whether any part of the difference was bond discount, were left to the jury. In the instant case respondent apparently does not contend that the fair market value of the preferred stock was other than $33 a share in July based on asked and bid prices for small quantities but does contend that this price in no way indicates the fair market value of the bonds had they been put up for sale for cash. Under the holding of the Court in the *Atchison, Topeka & Santa Fe* case, we would have to determine whether all of the circumstances surrounding the issuance of the bonds were "typical of the circumstances that might compel a corporation to discount its bonds." Our conclusion that under the circumstances of this case the $50 originally paid in for the preferred stock is the amount to be considered as paid in for the debenture bonds, might be considered to be a holding that no part of any difference which might exist between the fair market value of the National Alfalfa preferred stock and the face amount of the bonds issued in exchange therefor has been shown to be bond discount under the circumstances surrounding the issuance of the bonds in this case. If our conclusion that the bonds under the circumstances of this case were not issued at a discount is considered to be such a holding, then our conclusion in the instant case is supported by, and in no way in conflict with the *Atchison, Topeka & Santa Fe* case. There is no affirmative evidence in

We therefore conclude that petitioner is not entitled to bond discount amortization based on the difference in the $50 face value of its bonds issued in exchange for its preferred stock and the fair market value of the stock at the date of issue of the bonds but rather that the bonds were issued for stock which represented a $50 payment to petitioner.

Reviewed by the Court.

Decision will be entered for respondent.

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this case of circumstances surrounding the issuance of the bonds which would indicate what the fair market value of the bonds were at the time they were issued.

APPENDIX B

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

January Term—1973

No. 72-1125

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

ON APPEAL FROM THE UNITED STATES TAX COURT

(Docket No. 1081-70)

Charles White Hess (Ronald B. Stang and Linde, Thomson, Van Dyke, Fairchild & Langworthy on the briefs) for petitioner-appellant.

Ernest J. Brown, Atty., Dept. of Justice, (Scott P. Crampton, Asst. Atty. General, and Meyer Rothwacks, Atty., Dept. of Justice, on the brief) for respondent-appellee.

Stuart S. Opotowsky, Alan D. Berlin, Walter J. Rockler, Julius M. Greisman, Richard L. Hubbard, and Arnold & Porter, of counsel, on the brief for Norton Simon, Inc., amicus curiae.

Before PHILLIPS, HILL and HOLLOWAY, Circuit Judges.

PHILLIPS, Circuit Judge.

National Alfalfa Dehydrating and Milling Company, hereinafter called National Alfalfa, was incorporated under the laws of Delaware on May 4, 1946. It was authorized to engage and did engage in the business of dehydrating and milling alfalfa.

The question presented in this case is whether National Alfalfa incurred amortizable and deductible bond issue discount, deductible as interest paid, when it issued its 18-year, five per cent, sinking fund debenture bonds, hereinafter referred to as debentures, each for the principal sum of $50, to the preferred stockholders in exchange for their preferred stock, on the basis of one $50 debenture for each share of preferred stock of the par value of $50, when at the date of the exchange the fair market value of the preferred stock was only $33 per share.

Prior to July 23, 1957, National Alfalfa had issued an outstanding 47,059 shares of $50 par value, five per cent, cumulative preferred stock in an aggregate par value amount of $2,352,950, and as of that date there was a dividend arrearage on each of such shares of $10. Such preferred shares were redeemable at the discretion of National Alfalfa, in whole or in part, at prices ranging from $53 per share for shares redeemed prior to December 1, 1949, to $51 per share for shares redeemed after December 1, 1955, plus accumulated and unpaid dividends down to the date of redemption.

When redeemed, such preferred shares could not be reissued by National Alfalfa, but had to be cancelled and retired by it.

National Alfalfa was required to set aside annually after September 1, 1948, 20 per cent of its consolidated net earnings, after a payment of accrued

dividends on its outstanding preferred stock, for the purpose of redeeming preferred shares, as long as any were outstanding. However, such preferred shares could not be redeemed with funds in the sinking fund, nor purchased or acquired for value by National Alfalfa at any time when there were dividend arrearages thereon, unless consented to by the holders of 50 per cent of the preferred shares, or unless National Alfalfa notified all of its preferred shareholders of its desire to purchase such shares and invited them to tender offers.

On April 8, 1957, the Board of Directors of National Alfalfa adopted several resolutions, which are set out in Note 1 hereto.

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[1] The text of the resolutions is as follows:

"RESOLVED, that the officers of the Company, be and they are hereby authorized to effectuate a reorganization of the Company by way of recapitalization, and

"RESOLVED, that the President or Vice-President and the Secretary or Assistant Secretary of the Company be and they are hereby authorized to enter into a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, dated, as of July 1, 1957, pursuant to the terms of which there shall be issued $2,352,950.00 principal amount 5% Debentures, due July 1, 1975, which said bonds shall be issued in exchange for shares of the 5% Cumulative Preferred Stock on the basis of $50.00 principal amount of such debentures for each share of preferred stock and that this resolution, when ratified by the shareholders shall constitute authority for said issue, and

"RESOLVED, that the Company be authorized to issue warrants for the purchase of the common stock of the Company to each preferred shareholder participating in the exchange of his preferred stock for Debentures of the Company in the reorganization effective August 1, 1957, on the basis of one warrant for each share of Pre-

ferred Stock surrendered, said warrants to evidence the right to purchase one-half (½) share of common stock and said warrants to be exercisable to purchase only full shares of common stock of the Company at a price of $10.00 per share at any time from the date of issue until July 1, 1969 or so long as any debenture bonds remain outstanding, after which date warrants will become void, and

"RESOLVED, that the Company increase the par value of its shares from $1.00 to $3.00 and that the amount of $1,580,000.00 be transferred from Paid-In-Capital to the Capital Account in order to effectuate this resolution and reflect the increase in par value of the Common Stock, and

"RESOLVED, that the Articles of Incorporation of the Company be amended by changing Article FOURTH to read as follows:

> " 'The total number of shares of stock which the Corporation will have authority to issue is 1,000,000 shares of Common Stock of the par value of $3.00 per share.
>
> The minimum amount of capital with which the Corporation will commence business will be $1,000.00.'
>
> "1. Each share of Common stock shall be entitled to one vote per share in any matter requiring a vote of shareholders and each share shall be entitled, upon any liquidation, dissolution, or winding up of the affairs of the Corporation, whether voluntary or involuntary, to participant pro-rata in the assets available for distribution.
>
> "2. No holder of shares of stock of the Corporation shall be entitled, as such, to subscribe to or purchase any additional shares of stock, whether now or hereafter authorized, or obligations convertible into any class or classes of stock, or shares of stock of any class convertible into any class or classes, or obligations, shares of stock or other securities carrying warrants or rights to subscribe to shares of

stock of the Corporation of any class or classes, in any case whether now or hereafter authorized, but any and all shares of stocks, bonds, debentures or other securities or obligations, whether or not convertible into stock or carrying warrants or rights entitling the holders thereof to subscribe to stock may be issued, sold or disposed of from time to time by the Board of Directors to such persons, firms or corporations and for such consideration, so far as may be permitted by law, as it shall from time to time in its absolute discretion determine, without offering the same to the holders of shares of stock of the Corporation or any class then outstanding.

"3. The Company shall be entitled to issue warrants for the purchase of common stock on such terms as the Board of Directors may determine but such warrants when issued shall be binding on future actions of the Board of Directors and the terms thereof shall not be altered, amended or repealed without the consent of such warrant holders, AND

"RESOLVED, that this resolution and the reorganization and recapitulation [sic] contemplated hereby be submitted to a vote of the shareholders, and if adopted by the requisite number of shareholders, all rights and privileges of the 5% Cumulative Preferred Shares heretofore expressed or inherent in the ownership of said Preferred Stock shall cease and determine as of August 1, 1957, except such right to surrender the said shares of stock on the terms herein contained except as otherwise provided by law, and

"RESOLVED, that the officers of the Company be hereby authorized to submit the Plan of Reorganization to the Commissioner of Internal Revenue in an attempt to have the said Plan qualified as a tax free reorganization under the Internal Revenue Code of 1954, and

"RESOLVED, that the officers of the Company be hereby authorized to incur any and all necessary expenses to effectuate the Plan of Reorganization approved and adopted by this meeting of the Board of Directors."

The Board of Directors, by such resolutions, approved certain corporate actions, which, if approved by a two-thirds vote of each class of its shareholders and carried out, would constitute a reorganization of National Alfalfa within the meaning of 26 U.S.C.A. § 368(a)(1)(E). Such actions were:

1. The entering into of a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, as trustee, dated July 1, 1957, pursuant to the terms of which there would be issued $2,352,950 principal amount five per cent debentures, due July 1, 1975, and such debentures would be exchanged for all the shares of the outstanding cumulative preferred stock of National Alfalfa on the basis of one debenture for the principal amount of $50 for each share of such preferred stock of the par value of $50;

2. The issuance to each preferred stockholder participating in the exchange of his preferred stock for debentures of warrants effective August 1, 1957, for the purchase of common stock of National Alfalfa, on the basis of one warrant for each share of preferred stock exchanged, such warrants evidencing the right to purchase one-half share of common stock, but exercisable only for the purchase of full shares of such common stock at $10 per share at any time from the date of issue of such warrants to July 1, 1969; such warrants to be issued to and accepted by preferred stockholders participating in the exchange in lieu of the arrearage of cumulative dividends on their preferred stock;

3. (a) The amendment of the articles of incorporation of National Alfalfa, so as to provide for the issuance only of common stock;

(b) Increasing the number of shares of common stock from 763,000 to 1,000,000, and increasing the par value of the stock from $1 to $3.

The principal purpose of the reorganization was to enable National Alfalfa to extend easterly the territory in which it did business and effect a 50 per cent increase in its borrowing credit, which would be required by it for carrying the increased inventory which would result from such expansion. Such increase in the borrowing credit of National Alfalfa would be accomplished by issuing the five per cent debentures to the preferred stockholders in exchange for their preferred stock and the issuance to the preferred stockholders of the warrants to purchase common stock in discharge of the cumulative dividend arrearage.

The resolutions adopted by the Board of Directors of National Alfalfa were duly approved by the requisite number of votes of each class of stockholders at the regular annual meeting of National Alfalfa, held on July 23, 1957, and thereafter all of such resolutions were carried out.

National Alfalfa delivered to each of its preferred stockholders one $50, five per cent, debenture for each share of preferred stock held by such stockholders, and each of such stockholders delivered to National Alfalfa all of the shares of preferred stock held by him, and National Alfalfa retired such preferred stock.

In replying to a request for a ruling by Fidelity-Philadelphia Trust Company, the Treasury Department said in a letter to the Trust Company that no gain or loss would be recognized on the exchange of the $1 par value common stock for $3 par value common stock under the provisions of § 368(a)(1)(E) of

the Internal Revenue Code of 1954, but gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for debenture bonds.

National Alfalfa also delivered to each of such preferred stockholders and each of them accepted warrants to purchase common stock of National Alfalfa, as set forth above, in satisfaction of the dividend arrearage on his preferred stock.

The indenture required that National Alfalfa should create a sinking fund for the retirement of the debentures by the following provision:

> "The Company (National Alfalfa) covenants and agrees that on or before the expiration of 90 days after the end of each fiscal year of the Company commencing with the fiscal year ending April 30, 1959, it will pay to the Trustee as and for a contingent sinking fund for the redemption of Debentures at the sinking fund redemption price of 100% of the principal amount of the Debentures so to be redeemed, together with accrued interest to the redemption date, a sum in lawful money of the United States of America sufficient to redeem $196,080 principal amount of said Debentures, provided that in any year when the Consolidated Net Income is insufficient to redeem $196,080 principal amount of said Debentures the amount required to be paid over to the Trustee shall be 100% of such Consolidated Net Income and the difference between that sum and $196,080 shall accumulate to be paid from the Consolidated Net Income of subsequent years and provided further that the Company must commence the accumulation of income for sinking fund purposes by setting

aside 100% of Consolidated Net Income up to $196,080 in each year commencing with the year beginning May 1, 1957."

National Alfalfa has never been in default in the performance of anything required to be done by it by the terms of the debentures and the indenture.

On April 30, 1967, only 11,626 of the original debentures issued by National Alfalfa remained outstanding, and it had redeemed or otherwise repurchased and retired the other 35,433 debentures issued by it.

As shown by over-the-counter bids to purchase and offers to sell, the fair market value of each share of the preferred stock on July 23, 1957, was $33.

The debentures expressed unconditional and legally enforceable obligations on the part of National Alfalfa to pay the face amount thereof, with accrued interest, at the times and in the manner provided therein.

The indenture provided that:

"This Indenture and the Debentures issued hereunder shall be subordinate only to current bank borrowings for inventory purposes which obligations mature by their original terms in less than twelve months and obligations of the Company (National Alfalfa) to suppliers of materials, services and labor incurred in the normal course of the Company's business and reasonably required in its operations, which obligations are due and payable when billed, and to any existing liens, encumbrances, mortgages, conditional sales agreements, or pledges, or any replacement, renewal, or extension thereof * * *"

and, unless consented to by the holders of at least 66⅔ per cent of the debentures outstanding when done, it should not be subordinated to any funded debt created, issued, assumed, or guaranteed by National Alfalfa or any subsidiary thereof, with certain enumerated exceptions.

The indenture contained many other provisions for the protection of the priority of the debentures and the rights of the debenture holders, but it would unduly lengthen this opinion to set them out in detail.

In its income tax returns for its fiscal years ending April 30, 1958, through April 30, 1967, National Alfalfa claimed deductions for interest paid by reason of the debenture discount alleged to have resulted from the difference between the fair market value of $33 of the preferred stock on July 23, 1957, and the face amount of the debentures then issued by it to the holders of its preferred stock. These deductions were computed on the basis of straight line amortization of the interest discount and the amortized amounts with respect to debentures retired in those years. The deductions in earlier years were included in losses carried over to the fiscal year ending April 30, 1967.

The Commissioner of Internal Revenue disallowed National Alfalfa's claimed deduction of $109,804 for interest paid, resulting from debenture discount for its fiscal year ending April 30, 1967, and also disallowed $321,657 of claimed deductions for interest paid, resulting from like discounts for the fiscal years ending April 30, 1958, through April 30, 1966, and determined deficiencies accordingly. Upon National Alfalfa's petition to the Tax Court to review the action of the Commissioner, the Tax Court affirmed the deficiencies asserted by the Commissioner. From the

decision of the Tax Court, National Alfalfa has appealed to this court.

The decision of the Tax Court was based on the asserted proposition that where a corporation has issued its five per cent cumulative preferred stock at a stated par value (here, $50 per share) and thereafter issues its $50 debentures obligating it to pay the principal thereof at the times stated therein, and in the indenture under which the debentures were issued, together with interest at a stated percentage (here, five per cent) at the times stated in the debentures (here, semiannually), and exchanges such debentures for its preferred stock on the basis of one debenture for each share of preferred stock, although the market value of the preferred stock is less than its par value at the time of the exchange (here, $33 per share, or $17 less), thus giving the preferred shareholders a discount from the stated principal amount of the debentures (here, a discount of $17 per share), a corporation issuing the debentures (here, National Alfalfa) is not entitled to a discount reduction as for interest paid, amortized over the life of the debentures, for the reason it received for each preferred share at the time it was issued the identical amount of the stated principal payable under each debenture and therefore suffered no loss. And it so held; notwithstanding while the Treasury Regulations originally treated bond discount as a loss, since prior to 1957 they have treated it as interest paid,[2] which is supported by respectable authority, as we shall hereafter show.

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[2] See American Smelting & Refining Co. v. United States, 3 Cir., 130 F.2d 883, 885 (1942); Treas. Reg.. 33, Rev. Art. 150; Treas. Reg. 45, Art. 554(3)(a); Treas. Reg. 62, Art. 545(3)(a); Treas. Reg. 65, Art. 545(3)(a). The Treasury

The applicable Regulation in effect during the taxable year here involved is Treas. Reg. § 1.61-12(c)(3), T.D. 6272, 1957-2 Cum. Bull. 18, 32, which in part here pertinent reads:

> "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds."

Section 1.61-12(c)(3) was amended in 1968 by T.D. 6984, 1969-1 Cum. Bull. 38, and the pertinent language of the former Regulation was carried over to current Treas. Reg. § 1.163-3(a)(1).

A taxpayer has the unqualified right under the Federal Income Tax statutes to deduct from his gross income in a tax year interest actually paid in such year in a bona fide transaction.

As above stated, the Treasury Department, at all times here pertinent, has held that bond or debenture discount is deductible, not as a loss, but as interest paid, amortized over the life of the bond or debenture.

And as we shall show, infra, with the exception of the Court of Claims, the courts that have passed on the question have held that bond or debenture discount arises when the issuer of bonds or debentures exchanges them for preferred stock or securities theretofore issued by it, of less value than such bonds or debentures, and that such difference in value is deductible as interest prorated over the life of the bonds or debentures.

Assume that National Alfalfa sold 200 of its $50 debentures to John Doe at a discount of $17 per

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Regulation in effect during the taxable year here involved is § 1.61-12(c)(3), T.D. 6272, 1957-2 Cum. Bull. 18, 32.

debenture and received $6,600 for such debentures; and in the same tax year that it sold such debentures, it purchased from one of its preferred stockholders 200 shares of its $50 par value preferred stock at the market price of $33 per share. Could there be any doubt that National Alfalfa could deduct from its gross income the $17 discount on each of such debentures so sold as interest paid, amortized over the life of the debentures? We think the answer is obviously "No." Yet the $17 discount, plus $33, is exactly the same amount National Alfalfa received for such preferred shares when it sold them.

Assume the same facts stated in the above example, except National Alfalfa sold such 200 debentures at a discount of $17 per debenture to one of its preferred stockholders; and from the same stockholder in the same tax year purchased 200 shares of its preferred stock for $33 per share. Would there be any doubt of the right of National Alfalfa to likewise deduct from its gross income such $17 discount as interest paid, amortized over the life of the debentures? Again, we think the answer is obviously "No," yet as in the first example the $17 discount, plus $33 per share, is the same amount National Alfalfa received for each share of such preferred stock when it sold it.

In substance, there is no difference between the facts in the instant case and the facts in the second example stated above.

Hence, we hold that the decisions of the Commissioner and the Tax Court in the instant case are based on a nonapplicable premise, viz, that National Alfalfa suffered no loss.

At this point, we think it would be helpful if we show what the result would be if National Alfalfa

were permitted to deduct as interest amortized or prorated over the life of the debentures, which was 18 years, the difference between $50, the principal amount of each debenture, and $33, and market value of each certificate of preferred stock, or $17. That amount, prorated over the life of the debentures, would be 95 cents per year on each debenture, and would equal interest thereon at the rate of .019 per year. While the discount, in effect, would be paid in advance, the total deduction could not be taken in the tax year in which the exchange took place. It would have to be amortized over the life of the debentures. The picture looks quite different when the result is thus broken down.

The Tax Court relied principally on the decisions of the Court of Claims in Erie Lackawanna Railroad Company v. United States, 422 F.2d 425 (1970), and Missouri Pacific Railroad Company v. United States, 427 F.2d 727 (1970).

In the former case, the Railroad Company, after being authorized so to do by the Interstate Commerce Commission, exchanged its five per cent debentures, due January 1, 2020, for shares of Series "A" five per cent preferred stock. The basis of the exchange was one income debenture in the principal sum of $100 for one share of preferred stock having a par value of $100. The market value of the preferred stock at the time of the exchange of the debentures for stock was $22,558,224.46, which was $5,217,975.54 less than the $27,776,200 maturity value of the debentures. The Railroad Company claimed such difference represented bond discount and was deductible as interest paid, amortized over the life of the debentures. The Court of Claims held that the Railroad Company was not entitled to deduct such discount,

since the amount received by it for its preferred stock when issued was the same as the principal amount of the debentures, and therefore it suffered no loss in the exchange. In the opinion, the court said:

> "The position which this court does take in regard to the issue at hand is that since plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction. Since there was no actual difference between the face value of the debentures and the amount received in return for them ($100 preferred stock), there was no discount which could be amortized over the life of the bonds. The fact that the preferred stock had a market value less than $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock. What is important in this case is the value received for the stock at the time of its issuance. Since plaintiff issued its stock for $100 per share and carried the stock on its books at this amount, this is the figure which should be used to determine whether a discount has arisen. * * *"

In the latter of the two cases, Missouri Pacific and its subsidiaries reorganized in a proceeding under 11 U.S.C. § 205, pursuant to a plan approved by the Interstate Commerce Commission and the United States District Court having jurisdiction of the reorganization proceedings. Under the plan, Missouri Pacific issued: (1) Collateral trust notes; (2) first mortgage 4¼ per cent bonds (series B and C); (3) gen-

eral mortgage income 4¾ per cent bonds (series A and B); (4) 5 per cent 90-year debentures; and (5) stock in exchange for its own outstanding debt securities and stock of its subsidiaries; and the subsidiaries were merged into the parent corporation.

The terms of the exchange varied. In some cases, bondholders received new debt securities equal in amount to the sales value of the sum total of their bonds, plus interest accrued and unpaid by Missouri Pacific and its subsidiaries during the process of the reorganization. The accrued interest was deducted by Missouri Pacific from its gross income for federal income taxes in the year it became due. It also took deductions for amortized bond discount, predicated on the fact that the aggregate value of the new bonds issued pursuant to the plan was greater than the value of the securities received in exchange, as shown by New York Stock Exchange price quotations. Missouri Pacific claimed that the aggregate maturity value of the bonds was $529,117,141, while the fair market value of the old securities received in the exchange was $452,151,252, or a difference of $76,965,889, and that such difference in value represented debt discount and was deductible as interest amortized over the life of the new bonds. The court held that Missouri Pacific was not entitled to deduct such discount, because the par value of the old bonds when issued was their "true valuation * * * so far as plaintiff (Missouri Pacific) is concerned." The court held that for the purpose of income tax deduction for bond discount, bonds received in exchange for new bonds are in a completely separate category from other types of property received for the new bonds, and that the value of the old bonds so exchanged should be the amount received therefor by Missouri

Pacific at the time they were issued, rather than their market value at the time of the exchange. In so doing, the court followed its decision in the Lackawanna case, where it held that the preferred stock of the Railroad Company was received by it in exchange for debentures; that the principal amount of the debentures was the same as that received for the preferred stock when issued; and it suffered no loss in the exchange and no discount was allowed.

The two Court of Claims decisions supported the decision of the Tax Court in the instant case, but there is other respectable authority to the contrary. Moreover, the two Court of Claims decisions and the decision in the instant case, as we have heretofore shown, are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered.

And we regard it as anomalous for the Department of the Treasury to hold in the instant case that National Alfalfa suffered no loss when it exchanged a $50 debenture for a share of preferred stock of the market value of $33, since it had received $50 for such share of preferred stock when it sold it, and to hold that the preferred stockholder realized a gain when he exchanged a share of preferred stock of a market value of $33 for a $50 debenture, when he paid $50 for such share of preferred stock when he purchased it.

It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein, together with interest thereon, at the times therein provided, and receives therefor the amount of the

principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.[3]

The reason for allowing the discount is that it represents the expense of borrowing. It serves "the same function as stated interest[4] and "represents a part of the cost of the borrowed capital."[5]

The rationale stated above, with respect to the present treatment of discount as the same as interest paid on borrowed money, was followed and applied in a well considered opinion in American Smelting & Refining Co. v. United States, 3 Cir., 130 F.2d 883. There, bonds were exchanged for preferred stock of a subsidiary of the issuer, when such issuer owned all of the common stock of such subsidiary. The market value of the preferred stock received by the issuer of the bonds was less than the principal of the bonds. The court there rejected the contention made in the instant case, and held that the difference between the sale value of the bonds and the market value of the preferred stock at the time of the exchange represented a discount and was deductible as interest amortized over the life of the bonds.

American Smelting was followed in two subsequent District Court cases in the Fifth and Seventh Circuits, respectively, in Southern Fertilizer & Chemical Co. v. Edwards, U.S.D.C. M.D. Ga., 167 F.Supp. 879 (1955), and Industrial Development Corp. v. United

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[3] Helvering v. Union Pacific Railroad Co., 293 U.S. 282 (1934).

[4] United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965).

[5] Helvering v. Union Pacific Railroad Co., 293 U.S. 282, 287 (1934).

States, D. Ill., 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (1956). Both cases involved the issuance of bonds in exchange for the issuer's preferred stock.*

In Montana Power Company v. United States, 3 Cir., 232 F.2d 541, cert. den. 352 U.S. 843, the court, while disallowing the discount under the facts of that case, at page 546 reaffirmed its decision in the American Smelting case.

The case of Atchison, Topeka and Santa Fe R. Co. v. United States, 10 Cir., 443 F.2d 147 (1971), which was an income tax refund suit, involved the reorganization of the then existing Atchison, Topeka and Santa Fe Railroad Company, hereinafter referred to as the "Old Company." The facts in that case were these:

On December 23, 1893, the Union Trust Company of New York, trustee under the first and second mortgage bonds of the Old Company, filed a complaint in the United States Circuit Court for the District of Kansas, requesting the appointment of a receiver for the properties of the Old Company. Receivers were appointed. On January 1, 1894, the Old Company defaulted in payment of interest on its general mortgage bonds. The Union Trust Company filed a second complaint on March 12, 1894, seeking foreclosure of the mortgage and sale of the railroad's property described in the mortgages. A reorganization took place in 1895, whereby the Atchison, To-

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* See also Nassau Lens Co. v. C.I.R., 2 Cir., 308 F.2d 39, where in answer to the contention of the Commissioner that "when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money," the court stated: "We find no support for such an assertion and reject it. See American Smelting & Ref. Co. v. United States, 130 F.2d 883 (3rd Cir. 1942)."

peka and Santa Fe Railway Company, hereinafter referred to as the "New Company," the present plaintiff and taxpayer in the action, was organized and acquired all the assets of the Old Company.

After the filing of the first complaint by the Union Trust Company in 1893, bondholder protective committees were quickly formed throughout the country. The stockholders later established the Atchison Protective Reorganization Committee to protect their interests. Following various negotiations, three of the existing bondholder committees created the Joint Executive Reorganization Committee. After arm's length negotiations with the other groups of security holders, the Joint Executive Committee formulated and proposed a plan of reorganization for the Old Company, which was finally approved on April 10, 1895. It proposed the foreclosure of the general mortgage, also referred to as the first mortgage, and the vesting of the properties acquired at the foreclosure sale into the New Company.

Under the plan, the general mortgage bondholders, the second mortgage bondholders, and the income bondholders of the Old Company were to place their respective securities in various depositories and receive in exchange therefor certificates of deposit; and the stockholders of the Old Company were to place their stock in various depositories and receive in exchange therefor certificates of deposit. Under the plan, the holders of the second mortgage bonds, of the income bonds, and of common stock were to pay a cash assessment totaling approximately $14,000,000 into a depository in order to be eligible to receive certificates of deposit and to participate in the plan.

The plan specified what the holders of securities of the Old Company, respectively, would receive in bonds, or bonds and preferred stock, of the New Company in exchange for their certificates of deposit, and what the stockholders of the Old Company should receive in common stock of the New Company in exchange for their certificates of deposit.

On August 27, 1895, the Union Trust Company filed a supplemental complaint in the Circuit Court, requesting that the properties of the Old Company be sold as a single parcel. The Joint Executive Committee was allowed by the court to intervene in the reorganization proceedings, requested the Union Trust Company to go forward with the sale, and the court so ordered. A special master sold the property for $60,000,000 at a public auction on December 10, 1895, to Edward King, President of the Union Trust Company, Victor Marawetz, and Charles Beeman, all representing the Joint Executive Committee. The court approved the sale on the same day, decreeing that the purchasers could transfer the property to a new corporation, subject to certain restrictions, including provision for paying certain general mortgage bondholders of the Old Company who had elected not to participate in the plan.

The next day, December 11, 1895, the property was deeded to the three men. On December 12, 1895, the Joint Executive Committee incorporated the New Company, and the three men deeded the properties to it. The purchase price recited in the deed was $382,202,500, payable as follows: $96,990,500 par value of the New Company's general mortgage bonds; $51,728,000 par value of the New Company's adjustment mortgage bonds; $131,486,000 par value of the New Company's preferred stock; and 1,019,980

shares ($101,998,000 par value) of the New Company's common stock. The New Company delivered these securities and stock to the Joint Executive Committee, which placed them in the Union Trust Company. The Trust Company eventually effected the exchange of the old certificates of deposit for the securities of the New Company.

The basis of the New Company's claim for an income tax refund was that it issued general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable for federal income tax purposes.

At the trial below, the court ruled that in substance the bonds of the New Company were exchanged for the bonds of the Old Company, and submitted to the jury the questions of whether the fair market value of the bonds received was less than the par value of the bonds paid, and whether such difference constituted amortizable bond discount. The jury found a difference of $56,480,548, and decided that such amount constituted original issue discount.

This court held that the last step in the transaction determined the substance of what had occurred, and that the New Company issued its general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of the taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable as

interest paid for federal income tax purposes. The court said:

> "Clearly the taxpayer would have been entitled to a deduction for discount had the bonds been sold on the market at a discount, and the proceeds used to purchase the assets of the Old Company."

The court further held that there was no difference in substance between that and what actually happened in the reorganization proceeding, and cited the American Smelter Company case, in which it was said:

> "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash."

The court further stated:

> "This view conforms with economic and business reality which recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed. The taxpayer in this case presented substantial evidence from experts in railroad securities and properties who relied on the documents surrounding the reorganization, market conditions and actual trading, and valuation of the railroad properties as establishing the economic basis for and probable existence of discount * * *"

and affirmed the judgment of the lower court.

We repeat that we are of the opinion that the decisions of the Tax Court and of the Court of Claims are predicated on an unsound premise when they hold

that whether or not deductions shall be allowed, because of discount as interest paid, depends on whether the taxpayers claiming such deductions suffered a loss in the transactions.

We hold, because it is now settled by the decisions of the Supreme Court, that the deduction is for interest charged by reason of a discount, and not as a loss suffered by the taxpayer.[7]

The decision of the Tax Court sustaining the deficiency assessed by the Commissioner against National Alfalfa for its tax year ending April 30, 1967, and holding that there was a deficiency in income tax due from National Alfalfa for such tax year of $147,949.76 is REVERSED;

And the case is REMANDED, with instructions to direct the Commissioner to allow National Alfalfa to deduct from its gross income for such tax year that portion of the total debenture discount which is deductible as interest paid, amortized, or prorated over the life of the debentures, 18 years, allocable to such tax year ending April 30, 1967; and also to deduct an amount for loss carryovers from prior years, in view of our holding that the debenture discount was

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[7] We are also of the opinion that the case of Claussen's, Inc. v. United States, 5 Cir., —— F.2d ——, (decided November 16, 1972, 41 LW 2278) is clearly distinguishable on the facts from the instant case. In that case, the corporation involved not only issued its bonds in exchange for its outstanding Class A and Class B common stock, but also issued its new common stock to each of its old holders of Class A and Class B common stock, in direct proportion to their original equity interest in the corporation. The court held that the common stockholders' equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose.

deductible as interest paid, amortized over the life of the debentures, provided National Alfalfa was entitled to take a deduction in its return for its tax year ending April 30, 1967, for losses suffered in prior years, a question not raised nor passed on by this court on this appeal.

No. 72-1125

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

HILL, Circuit Judge, dissenting.

I am compelled to respectfully dissent from the majority opinion. My colleagues, in rejecting certain cases, in my opinion have done so on the basis of a rule of law gleaned entirely out of context when viewed with other cases in which this same problem is confronted.

The majority reject Erie Lackawanna Railroad Company v. United States, 422 F.2d 425 (Ct.Cl. 1970), and Missouri Pacific Railroad Company v. United States, 427 F.2d 727 (Ct.Cl. 1970), *modified*, 433 F.2d 1324 (Ct.Cl. 1970), *cert. denied*, 402 U.S. 944, on the basis that those cases "are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered." I agree with the majority to the extent that loss is not synonymous with discount, but rather that discount "serves 'the same function as

stated interest' and 'represents a part of the cost of the borrowed capital.'" I must conclude, however, the concept of loss as used in those cases is correct when read in context with other cases.

In St. Louis-San Francisco Railway v. United States, 444 F.2d 1102, 1106 (Ct.Cl. 1971), *cert. denied*, 404 U.S. 1017, the court there rejected any discount in either of two exchanges on the basis "that there was an exchange of equals." In analyzing its decision in Erie Lackawanna, the court stated discount was not allowed in that case because "equivalents had been exchanged and no discount could be said to arise." When loss is thus analyzed in the context of whether there was a disparity in values in an exchange, those cases rejected by the majority are clearly authoritative.

A further example of application of this "equivalency of exchange" formula is provided in Cities Service Company v. United States, 316 F.Supp. 61 (S.D. N.Y. 1970). In that case there was a disparity in values in an exchange of debentures for preferred stock due to the higher value of the debentures being offered in exchange. The court there allowed discount measured by the amount of that disparity. That excess represented the true additional consideration which the company was required to pay in retiring its outstanding preferred stock.

The cases cited applying the equivalency of exchange formula have uniformly held that where the corporation is retiring its own outstanding bonds or stock in an exchange transaction, the value to be ascribed those outstanding bonds or stock shares is the value originally received by the corporation in exchange for that outstanding obligation. I am not persuaded that the cases cited in the majority opin-

ion require fair market value to be ascribed the outstanding obligations, as those cases are distinguishable. Both Atchison, Topeka and Santa Fe Railway Co. v. United States, 443 F.2d 147 (10th Cir. 1971), and American Smelting & Refining Co. v. United States, 130 F.2d 883 (3d Cir. 1942), involved corporations exchanging their debt obligations for the outstanding obligations of another corporation. In both cases, the corporation assuming the outstanding obligations was not the corporation which had originally received the consideration for those obligations. This distinction was noted in Erie Lackawanna, supra, and remains viable today, although apparently modified to the extent that the value of outstanding obligations of a subsidiary, when assumed by the parent corporation, is the consideration originally received by the subsidiary rather than the market value of the outstanding obligation.[1] Market value is therefore relevant only when the assuming corporation is other than the corporation which originally issued the obligation.

I would note also that Southern Fertilizer & Chemical Co. v. Edwards, 167 F.Supp. 879 (M.D.Ga. 1955), and Industrial Development Corp. v. United States, 51 A.F.T.R. 1514, 56-2 U.S.T.C. ¶ 10,066 (D.Ill. 1956), on which the majority rely, contain only findings of fact and conclusions of law with no detailed discussion of the question. I therefore, as did the court in Erie Lackawanna, reject those cases as authoritative. I likewise distinguish Montana Power Company v. United States, 232 F.2d 541 (3d Cir. 1955), *cert. denied*, 352 U.S. 843, on the facts, as

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[1] *See* Missouri Pac. R.R. Co. v. United States, 427 F.2d 727 (Ct.Cl. 1970), *modified*, 433 F.2d 1324 (Ct.Cl. 1970), *cert. denied*, 402 U.S. 944.

the issue presented there related to proof of value of property originally exchanged for the corporate obligation. We are here confronted with an exchange of a subsequent corporate obligation for a prior obligation.

My close reading of the cases reveals a formula to be followed when a corporation issues its debt obligation in exchange for its own prior outstanding obligation. In applying this formula, the value assigned the outstanding obligation is the consideration received by the corporation when originally issued. Any discount, therefore, is dependent on a showing of disparity in values reflected by the higher value of corporate debt obligation given in exchange. If there is no disparity in value, that is, if there is an equivalency in the exchange, no discount arises. The facts here clearly show only equivalent exchanges. I would, therefore, affirm the decision of the Tax Court.

APPENDIX C

JANUARY TERM—JANUARY 26, 1973

Before Honorable Orie L. Phillips, Honorable Delmas C. Hill and Honorable William J. Holloway, Jr., Circuit Judges

No. 72-1125

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

This cause came on to be heard on the record on appeal from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered that the decision of the Tax Court sustaining the deficiency assessed by the Commissioner against National Alfalfa for its tax year ending April 30, 1967, and holding that there was a deficiency in income tax due from National Alfalfa for such tax year of $147,949.76 is reversed and the case is remanded, with instructions to direct the Commissioner to allow National Alfalfa to deduct from its gross income for such tax year that portion of the total debenture discount which is deductible as interest paid, amortized, or prorated over the life of the debentures, 18 years, allocable to such tax year ending April 30, 1967, and also to deduct an amount for loss carryovers from prior years, in view of our holding that the deben-

ture discount was deductible as interest paid, amortized over the life of the debentures, provided National Alfalfa was entitled to take a deduction in its return for its tax year ending April 30, 1967, for losses suffered in prior years, a question not raised nor passed on by this court on this appeal. Hill, Circuit Judge, dissenting.

A true copy

Teste

HOWARD K. PHILLIPS
Clerk

By: /s/ Lavon M. Irlbeck
LAVON M. IRLBECK
Deputy Clerk

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * *

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

* * * *

(b) *Definitions.*—

(1) *Original issue discount.* — For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) [as amended by Sec. 5, Interest Equalization Tax Act, P.L. 88-563, 78 Stat. 809, and Sec. 413(b), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487] *Issue price.*—In the case of issues of bonds or other evidences of indebtedness registered

with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond increased by the amount, if any, of tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. In the case of a bond or other evidence of indebtedness and an option or other security issued together as an investment unit, the issue price for such investment unit shall be determined in accordance with the rules stated in this paragraph. Such issue price attributable to each element of the investment unit shall be that portion thereof which the fair market value of such element bears to the total fair market value of all the elements in the investment unit. The issue price of the bond or other evidence of indebtedness included in such investment unit shall be the portion so allocated to it. In the case of a bond or other evidence of

indebtedness, or an investment unit as described in this paragraph (other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or an insolvency reorganization within the meaning of section 371, 373, or 374), which is issued for property and which—

(A) is part of an issue a portion of which is traded on an established securities market, or

(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

* * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.61-12 [as republished in T.D. 6500, 25 Fed. Reg., Part 11, pp. 11402, 11442-11443] *Income from discharge of indebtedness.*

* * * *

(c) *Sale and purchase by corporation of its bonds.* * * *

* * * *

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

* * * *

§ 1.163-3 [as amended by T.D. 6984, 1969-1 Cum. Bull. 38] *Deduction for bond discount.*

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3).

* * * *

Examples. The rules in paragraph (a) of this section are illustrated by the following examples:

Example (1). M Corporation, on January 1, 1960, the beginning of its taxable year, issued for $95,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. M Corporation should treat $5,000 ($100,000-$95,000) as the total amount to be amortized over the life of the bonds.

* * * *

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